Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:PHI:TL-N-5114-00
RHGannon

date: NOV 22 2000

to: Group 1E:1563/LMSB/RFP
Philadelphia, Pennsylvania
Attn: Revenue Agent Stephen Gorman

from: Associate Area Counsel (LMSB) - Philadelphia
Richard H. Gannon, Special Litigation Assistant

subject: [redacted]
Form 1120S [redacted] through [redacted]
Request for Legal Assistance

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY- CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANY ONE OUTSIDE IRS, INCLUDING THE TAXPAYER INVOLVED. LIMIT USE OF THIS DOCUMENT TO THOSE WITHIN THE SERVICE WORKING ON THIS CASE. THIS DOCUMENT CONTAINS "RETURN INFORMATION" AS THAT TERM IS DEFINED BY I.R.C. § 6103(b)(2) AND THE DISCLOSURE THEREOF IS PROHIBITED EXCEPT AS AUTHORIZED BY THE INTERNAL REVENUE CODE OF 1986.

In your memorandum dated August 31, 2000, you pose a number of questions relating to the purported sale of goodwill by [redacted] to [redacted][1] in [redacted]. You particularly question the taxpayer's characterization of the transaction as a sale of goodwill. Our office has reviewed the many agreements documenting the transaction described below and generally agrees that the transaction in question was something other than it seemed. Since further factual development is desirable before any final determination is made, any formal reference of this matter by way of a request for technical or field service advice will be deferred pending that further factual development. As discussed below, this matter is factually intensive and can probably be resolved on the basis of uncontroversial principles of tax law.

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[1] [redacted], the taxpayer, will be hereinafter referred to as "[redacted]" while the new entity, [redacted], formed at or around the time of the purported sale of goodwill, will be hereinafter referred to as "[redacted]." [redacted] [redacted]'s founder, will be referred to as "[redacted]."

FACTS:

During the period in question, [redacted] was a [redacted] professional corporation engaged in the practice of public accounting. In addition to its thriving accounting practice, [redacted] engaged in the related business of financial consulting, particularly in the area of [redacted] Business). [redacted] was the founder of [redacted], and was apparently responsible for much of the firm's success. By all reports, he controlled the firm from the date of its founding until the sale of the firm in [redacted].

In [redacted], [redacted] and its shareholders entered into an agreement with its shareholders (the "[redacted] Shareholders' Agreement") providing for the redemption of [redacted] shares upon the death, retirement or other "triggering event" such as bankruptcy or termination of a shareholder's employment by [redacted]. In the case of [redacted], the [redacted] Shareholder's Agreement provided for a purchase or redemption price of $[redacted].

In [redacted], [redacted] and its shareholders entered into a new agreement (the "[redacted] Shareholder's Agreement") providing that the shares of a departing shareholder were to be first offered to the remaining shareholders in the ratio the number of each remaining shareholder's shares bore to the remaining shares.[2] If, and to the extent the shares so offered were not taken, the obligation to purchase shares was shifted to [redacted] itself. As in the case of the [redacted] Shareholder's Agreement, the price to be paid for a departing shareholder's shares was agreed, with provision made for allocating part of the price to a restrictive covenant and part to the shares themselves, although, unlike the [redacted] Agreement, half the purchase price of a departing shareholder's shares was allocated to the restrictive covenant on the schedule used to list the prices paid to each departing shareholder.[3] Under the [redacted] Shareholder's

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[2] Some of [redacted]'s employees were "phantom equity" owners. As such, they were apparently entitled to share in earnings, dividends and liquidation proceeds in the same manner as regular shareholders but were not entitled to vote their stock. This memorandum does not reach the question of whether this "phantom equity" constituted a second class of stock, thereby jeopardizing [redacted]'s status as a Subchapter S Corporation.

[3] Unlike the [redacted] Agreement, the [redacted] Shareholder's Agreement did not distinguish between the purchase of a dying shareholder's shares and the purchase of the shares of a shareholder departing [redacted] for a different reason. It is difficult to justify a payment made pursuant to a covenant not to compete triggered by the death of the person agreeing not to compete.

Agreement, [redacted]'s board was to publish a new schedule of prices each year based on the prices set in the prior schedule increased or decreased by the net operating income or loss realized by [redacted] during the interim. Under the [redacted] Shareholder's Agreement, [redacted] was entitled to payments of $[redacted] for his shares and $[redacted] for his covenant not to compete, each in [redacted] monthly installments, with interest at [redacted]% per annum, commencing on his [redacted]th birthday.[4]

At the same time [redacted] and its shareholders entered into the [redacted] Shareholder's Agreement, [redacted] and [redacted] entered into an agreement providing for the "separation" of [redacted] from [redacted] (the "[redacted] Separation Agreement"). After reciting that [redacted] was its founder "who more than any other individual has been responsible for the growth and profitability of the Company," the [redacted] Separation Agreement provided for the termination of [redacted]'s employment as of [redacted], the placement of his [redacted] shares in a voting trust, annual payments of $[redacted] to [redacted] until he reached age [redacted] ("severance benefits"),[5] and an additional severance benefit of not less than $[redacted] based on [redacted]'s available cash flow. The $[redacted] severance benefit was to be reviewed by [redacted] on an annual basis and could apparently be revised, although it could not be reduced without [redacted]'s written consent. The additional severance benefit of $[redacted] need not be made unless [redacted] first paid bonuses or incentive compensation to its employees who were shareholders or owners of phantom equity.

The [redacted] Separation Agreement also required [redacted] to provide [redacted] with an office, secretary, life insurance (in the amount of the purchase price of [redacted]'s [redacted] shares, health insurance, a $[redacted] car allowance, a cellular phone, together with other "perks" paid to its other shareholders or that the board of directors deemed appropriate. In addition, the [redacted] Separation Agreement entitled [redacted] to deferred compensation pursuant to a letter agreement between [redacted] and [redacted] dated [redacted]. Finally, the Agreement provided for the continuation of the severance benefits after [redacted] attained the age of [redacted], but before the repurchase of [redacted]'s stock was complete, at the discretion of [redacted]'s board of directors. In addition, [redacted] remained entitled to payments under the [redacted] deferred compensation agreement. If [redacted] died prior to attaining age [redacted], his wife was to receive the severance payments until the [redacted]th

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[4] The [redacted] Shareholder's Agreement does not specify whether interest is to run from the date of the [redacted] Shareholder's Agreement or from [redacted]'s [redacted]th birthday. You have advised us that [redacted] was approximately [redacted] years of age as of [redacted]. It has been assumed, except as indicated below, that interest ran from [redacted]'s [redacted]th birthday. Based on that assumption, and further assuming a [redacted]% discount rate, a $[redacted] payment, due in [redacted] years (assuming [redacted] was [redacted] as of [redacted], had a present value of approximately $[redacted] as of [redacted].

anniversary of [redacted]'s birth. No provision was made for continuation of the additional severance benefit.

Since [redacted] terminated his employment with [redacted] as a result of the [redacted] Separation Agreement, the provisions for the purchase of his shares under the [redacted] Shareholder's Agreement was triggered as of that time. As noted above, the remaining shareholders had the option to purchase their pro-rata share of his shares, with [redacted] retaining the duty to repurchase those [redacted] shares not purchased by the other shareholders under their options. It is not known whether any of the other [redacted] shareholders exercised their option pursuant to the [redacted] Shareholder's Agreement.

Section 5(e) of the [redacted] Shareholder's Agreement specifically sets forth provisions for the purchase of [redacted]'s shares, First, the price of the shares was set at $[redacted] including the amount allocated to the restrictive covenant. Second, the purchase price was to be paid in [redacted] equal monthly installments commencing when [redacted] attained the age of [redacted] with interest at the minimum rate of [redacted]%. Third, if [redacted] or its business was sold within [redacted] years of the date [redacted] commences the repurchase of [redacted]'s shares; i.e., when he attains the age of [redacted], [redacted] would be entitled to an additional payment in an amount equal to the difference between the amount he would have received had he not sold his shares under the Agreement and $[redacted].[6]

While the [redacted] Shareholder's Agreement makes provision for restrictive covenants, no such covenants are defined in that agreement.[7]

The [redacted] Separation Agreement defines certain covenants with respect to [redacted], prohibiting him from engaging in the performance of "accounting, consulting or related services" for, or being

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[6] There are a number of provisions (or lack thereof) in the two [redacted] agreements that suggest they were drafted in haste. For example, it is not clear whether [redacted] would have been entitled to any payment for his shares above $[redacted] when [redacted] sold out its business in the [redacted] of [redacted]. Under Section 5 of the [redacted] Shareholder's Agreement, this would apparently hinge on whether [redacted] was within [redacted] years of his [redacted]th birthday. A second example concerns the fact that the [redacted] Shareholder's Agreement allocates [redacted] the purchase price for a dying partner's shares to a restrictive covenant - an apparent absurdity - while the [redacted] Shareholder's Agreement specifically does not. Finally, there is the question of the [redacted] Employment Agreement, which is specifically cited in both [redacted] Agreements but which, so it is said, was never executed by [redacted]. The only common denominator running through the [redacted] Agreements is that they confer substantial benefits on [redacted], and apparently have little regard to the problems of the other shareholders.

[7] It is possible that the covenants in question are defined in the employment agreements mentioned therein. Copies of these agreements should be obtained from the taxpayer and analyzed.

associated with any entity that performs or solicits the performance of such services for any person or entity who was a "Client" of [redacted] over the preceding [redacted] years. A "Client" is defined as any "person or entity for which [redacted] or an Affiliate performed accounting, consulting or related services" for which the person or entity had or will be billed at the time of the Agreement. "Client" specifically includes clients brought in by [redacted]. The Agreement provides that "[redacted] shall have no right whatsoever to the business relating to any Client upon termination of this Agreement." The covenant in question runs for [redacted] years. [redacted] agrees not to disclose "methods or procedures developed by [redacted] nor the names of any of [redacted]'s clients for a period of [redacted] years. [redacted] also agrees not to attempt to hire away any of [redacted]'s employees for a period of [redacted] years. Finally, Section 6(e) of the Agreement provides that,

> Notwithstanding any provision contained herein to the contrary, [redacted] shall be permitted to engage in the business activities described on Schedule 1 attached hereto and made a part hereof.

In turn, Schedule 1 of the [redacted] Separation Agreement permits [redacted] to engage in a wide variety of activities, including "[f]inancial planning, management counseling, strategic planning, and advisory services."

Before we turn to the agreements executed in [redacted] (the "[redacted] Agreements,"), it is appropriate to summarize, to the extent possible, the rights and duties of [redacted] and [redacted] immediately prior to the [redacted] Agreements. First, as of [redacted], [redacted] owed [redacted] the sum of $[redacted] per year until he reached the age of [redacted]. We assume that this was approximately [redacted] years.[8] These payments were guaranteed; the duty to make them survived [redacted]'s death. Second, [redacted] was entitled to $[redacted] in annual deferred compensation under the letter agreement between [redacted] and its shareholder-employees dated [redacted]. Third, [redacted] is entitled to $[redacted], in [redacted] equal monthly payments commencing on his [redacted]th birthday, with interest at the minimum rate of [redacted]%. [redacted] is also entitled to an office, secretary, $[redacted] monthly car allowance, life insurance,[9] health insurance and other benefits.

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[8] The present value of annual payments of $[redacted] in equal monthly installments over a period of [redacted] years with an assumed interest rate of [redacted]% (the same rate provided for in the [redacted] Shareholder's Agreement) was approximately $[redacted].

[9] The proceeds of the life insurance policy are to be used to pay for his ([redacted]'s) stock upon his death.

Effective [redacted], [redacted] elected to be taxed as an S Corporation. This triggers the potential that built in gain might be recognized at the corporate level pursuant to I.R.C. § 1374(b).

The Amended & Restated Separation Agreement effective [redacted] ("[redacted] Separation Agreement"), executed in conjunction with the [redacted] Acquisition Agreement described below, substantially altered [redacted]'s rights under the [redacted] Separation Agreement. First, the [redacted] Separation Agreement recites that, in connection with the sale of [redacted]'s [redacted] consulting business to [redacted], [redacted] was consummating the repurchase of [redacted]'s [redacted] stock.[10] Second, the severance benefits awarded to [redacted] pursuant to the [redacted] Separation Agreement were reduced to a payment of $[redacted] (defined as the "Severance Amount") in [redacted] monthly installments of approximately $[redacted] each.[11] [redacted]'s deferred compensation of $[redacted] per month was continued, as was his $[redacted] monthly automobile allowance and his health insurance. Finally, [redacted] agreed to pay [redacted] the cost of [redacted]'s office until he reached the age of [redacted], and a consulting fee equal to [redacted]% of the gross margin realized by [redacted] from new client relationships procured by [redacted] for [redacted] until [redacted] reached age [redacted].[12] The restrictive covenants contained in the [redacted] Separation Agreement were continued unchanged.[13] The period of the covenants was increased from the [redacted] years provided in the [redacted] Separation Agreement to [redacted] years.[14]

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[10] Exhibit A to the [redacted] Agreement and Plan of Merger whereby [redacted]'s business was acquired by [redacted] indicates that a portion of the $[redacted] in cash and [redacted] in [redacted] shares paid to [redacted] was, in turn, to be paid to [redacted] to "satisfy and discharge certain liabilities and obligations of [redacted] to [redacted]. If you have not already done so, we suggest that attempts be made to determine what portion of the cash and [redacted] shares received by [redacted] was paid to [redacted] and the basis for determining the amount of the payment.

[11] The present value of these payments, assuming a [redacted]% interest rate, was $[redacted].

[12] No mention was made of life insurance, presumably because the life insurance coverage mandated by the [redacted] Separation Agreement was designed to fund the repurchase of [redacted]'s [redacted] shares.

[13] The only discernable change, perhaps unintended, was to increase the period within which [redacted] was barred from hiring away [redacted] employees from [redacted] years to [redacted] years.

[14] The covenants in the [redacted] Separation Agreement generally ran from the effective date of the agreement. The covenants in the [redacted] Separation Agreement ran for the [redacted] year period the revised severance payments were being paid plus an additional [redacted] years. Since the covenants contained in the [redacted] Agreement had a year to run in [redacted], the [redacted] Separation Agreement continued them in force for approximately [redacted] more years.

As noted above, the [redacted] Separation Agreement was executed in conjunction with an Asset Acquisition Agreement between [redacted] and [redacted] whereby the latter acquired [redacted]'s [redacted] Consulting Business. Under that agreement, [redacted] acquired [redacted] assets relating to the [redacted] assets including, among other things, accounts receivable, furniture and equipment, real property leases, licenses and permits, the right to use certain software programs and other know how and trade secrets, the books and records of the business, the right to occupy parts of [redacted]'s leased property and last, but not least, "the goodwill of the Business and the tangible items that embody such goodwill, including lists of clients, referral sources and suppliers." The purchase price for these assets was $[redacted]. plus the assumption of approximately $[redacted] in [redacted] liabilities, approximately $[redacted] in prepaid items, and the [redacted] common stock owned by the former shareholders of [redacted] moving over to [redacted] (worth approximately $[redacted] under the [redacted] Shareholder's Agreement. Schedules to the [redacted] Asset Acquisition Agreement list what appear to be tentative values for tangible personal property (equipment and fixtures) and accounts receivable at approximately $[redacted] and $[redacted] respectively and then allocate the "purchase price" of $[redacted] to tangible personal property and accounts receivable in the respective amounts of $[redacted] and $[redacted]. While [redacted] acquires a number of intangible assets, including, among others (1) "books and records, manuals, files, and operating data relating the [redacted] Business, (2) the rights under certain lawsuits both previously commenced and to be commenced relating to the [redacted] Business, and (3) "the goodwill of the [redacted] Business and the tangible items that embody such goodwill, including lists of clients, referral sources and suppliers." The [redacted] Asset Acquisition Agreement also recites that, on the date of the agreement, [redacted] has acquired "that portion of the goodwill of the Business owned by [[redacted]] for $[redacted], which amount is being paid to [redacted] on the date hereof."

Under the Consulting Agreement dated [redacted], [redacted] agreed to perform certain services for [redacted] for a "Consulting Fee" of $[redacted] payable in [redacted] monthly installments of approximately $[redacted] each. At any time after [redacted] years, [redacted] had the right to demand payment of the unpaid portion of the Consulting Fee in a lump sum upon [redacted] months notice.[15] In return, [redacted] agreed to furnish $[redacted] in marketable investments as collateral for the loan obtained by [redacted] to acquire [redacted]'s [redacted] consulting business, as

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[15] The present value of the payments under the Consulting Agreement was $[redacted] The Consulting Agreement permits [redacted] to demand payment of the unpaid portion of any unpaid consulting fees in a lump sum after [redacted] years, and gives the same right to [redacted]'s personal representative upon [redacted]'s death. The Consulting Agreement is silent as to whether the lump sum would be discounted to its present value at the time of its payment. Assuming that no discount was required, and that [redacted] elected to take a lump sum payment in [redacted] years, the present value of the consulting fees was $[redacted].

well those tasks assigned to him by the president of [redacted]. The duty to perform tasks was to remain in force only as long as [redacted] was president of [redacted], as long as [redacted] controlled the day to day operations of [redacted], and as long as [redacted] owned more than [redacted]% of [redacted]'s stock. The duty of [redacted] to pay the Consulting Fee survived [redacted]'s death. In addition, [redacted] had the right to direct the referral of any accounting business controlled by [redacted] to accounting firms and to keep any referral fees generated thereby. [redacted]% of those fees was to be credited against the Consulting Fee.

Finally, in a letter dated [redacted] and signed on behalf of [redacted], [redacted] and by [redacted] himself, [redacted] agreed to pay [redacted] $[redacted] for each of the [redacted] shares held in the [redacted] voting trust established in [redacted]. The [redacted] Shareholder's Agreement, executed on the same day, stated that the [redacted] trust owned [redacted] shares of [redacted] stock as of that date. The [redacted] Shareholder's Agreement, superceded by the [redacted] Shareholder's Agreement, obligated [redacted] to pay $[redacted] for the same shares and an additional $[redacted] for [redacted]'s covenant not to compete, each over a [redacted] year period commencing on [redacted]'s [redacted]th birthday, with interest at [redacted]%.[16]

In the same letter agreement, [redacted] agreed to purchase $[redacted] in investment grade securities with part of the $[redacted] received from [redacted] and to pledge that investment as collateral for the loan obtained by [redacted] to fund the agreement. As amended on [redacted], [redacted] agreed that, if and to the extent the collateral was not released from the pledge at the end of [redacted] years, [redacted] could elect to add the amount of that portion of the pledged collateral to the accelerated balance then due him under the Consulting Agreement of [redacted]. If [redacted] received no interest on the pledged securities, and assuming a discount rate of [redacted]%, the value of the securities to him as of [redacted] would be worth, at most, $[redacted].

In sum, under the [redacted] Agreements, as of [redacted], [redacted] was entitled to payments with a present value of $[redacted] for his shares and covenant not to compete, and separation payments with a present value of $[redacted]. He was also entitled to other payments and benefits that did not change as a result of the [redacted] Agreements. As a result of the [redacted] Agreements, and in lieu of the $[redacted] in payments described in the penultimate sentence, [redacted] was entitled to $[redacted] for his [redacted] shares from [redacted], $[redacted] in separation payments due from [redacted], $[redacted] in consulting fees due from [redacted], and a $[redacted] payment from [redacted]. The total due under

[16] The [redacted] Shareholder's Agreement does not specify when the [redacted]% interest begins to run, as of the date of the agreement in [redacted], or the date [redacted] turns [redacted], presumably in [redacted]. If the obligation bore interest from [redacted] the present value of the two $[redacted] obligations (for [redacted]'s shares and for the covenant not to compete) should be increased by at least $[redacted] each. If the proper discount rate applicable in computing the present value of these two obligations, as of [redacted], was more or less than [redacted]% per annum, the present values would vary accordingly.

the [redacted] Agreements of $[redacted] should be reduced by the discounted value of the $[redacted] that [redacted] was required to pledge to secure the [redacted] borrowings. As noted above, the discounted value of the pledged collateral is approximately $[redacted] thereby reducing the present value of the total due under the [redacted] Agreements to $[redacted].

We hasten to add that the values set forth above were tentatively calculated by the undersigned, who is decidedly not an expert in financial analysis or valuation. It is imperative that these values be recalculated or verified by somebody with the requisite expertise to qualify as an expert should court testimony be needed to defend the values ultimately determined.

DISCUSSION AND LEGAL ANALYSIS:

It has long been held that while taxpayers are generally bound to the form in which they agree to cast their transactions, they cannot contractually prevent the Service from looking to the substance of the transaction and attacking it where it is determined that it has no basis in economic reality. See, e.g., Commissioner v. Court Holding Company, 324 US 331 (1945), Gregory v. Helvering, 293 U.S. 465 (1935). On the other hand, the courts generally respect a taxpayer's attempt to structure his transactions to avoid tax as long as "the thing that was done was the thing which the statute intended." Gregory v. Helvering, supra at 469. This ordinarily invites a factual inquiry to discern the true nature of the transaction under examination.

As described above, the net effect of the [redacted] Agreements was to reduce [redacted]'s obligations to [redacted] from approximately $[redacted] to $[redacted]. At the same time, [redacted] sold the [redacted] Business to [redacted] for $[redacted]. [redacted] "realized" approximately $[redacted] on the sale of its [redacted] Business to [redacted]. As a second result of the [redacted] Agreements, [redacted] acquired the [redacted] Business plus [redacted]'s "goodwill" for a payment of $[redacted] to [redacted], a payment of $[redacted] to [redacted],[17] and consulting payments of $[redacted] to [redacted]. As a third result of the [redacted] Agreements, [redacted]'s rights to payments from [redacted] was reduced from $[redacted] to $[redacted] for a reduction of $[redacted]. At the same time, [redacted] received both current and future payments in the aggregate amount of $[redacted] from [redacted].

There is a strong basis for concluding that [redacted] realized $[redacted] on the sale of its [redacted] Business to [redacted], in lieu

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[17] $[redacted] less the discount on the $[redacted] in collateral pledged by [redacted] to secure [redacted] borrowings.

of the $[redacted] provided in the [redacted] Asset Acquisition Agreement. It further appears that a substantial portion of this amount represents a net built in gain under I.R.C. § 1374. The amount of the gain can only be determined after this amount is allocated among the assets transferred to [redacted] under the [redacted] Asset Acquisition Agreement and the adjusted basis of those assets in the hands of [redacted] is finally determined. While this memorandum does not express an opinion on the allocation of the redetermined purchase price, it seems clear that the values agreed in the [redacted] Asset Acquisition Agreement invite a detailed scrutiny.[18] The net built in gain, in the amount ultimately determined, is taxable to [redacted] pursuant to I.R.C. § 1374(b) despite its Subchapter S status.

Second, we believe that [redacted] realized the sum $[redacted] as the result of the [redacted] Agreements, including $[redacted] in cash as calculated above, $[redacted] representing the present value future separation payments from [redacted], and $[redacted] representing the future value of the payments due from [redacted] under the [redacted] Consulting Agreement. Of the amount of $[redacted] payable to [redacted] on [redacted] pursuant to the [redacted] Agreements, $[redacted] represented separation payments, which would have constituted ordinary income to him when received. As a result of the changes wrought by the [redacted] Agreements, this amount was reduced to $[redacted] ($[redacted] from [redacted] and $[redacted] from [redacted] under the [redacted] Consulting Agreement). The difference of $[redacted] should represent additional ordinary income to [redacted] for [redacted] while the future payments from [redacted] and [redacted] should be taxed when received. $[redacted] of the remainder should be allocated to [redacted]'s covenant not to compete under the [redacted] Shareholder's Agreement, and should also be taxed to him at ordinary rates. An additional $[redacted] should be treated as the amount realized by [redacted] on the redemption of his [redacted] stock.[19] leaving a balance of $[redacted] as calculated below. This amount should be allocable to [redacted]'s "goodwill."

<u>Amounts Realized by [redacted]</u>

Separation Payments from [redacted]	$[redacted]
Consulting Agreement with [redacted]	[redacted]
Cash Payment from [redacted]	[redacted]

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[18] As noted above, the parties allocated the $[redacted] "purchase price" between accounts receivable ($[redacted]) and tangible personal property ($[redacted]). There is a strong argument for the proposition that this allocation should be respected by the courts in so far as it represents the parties' agreement as to how the $[redacted] should be allocated between these two items.

[19] We have ignored the $[redacted] payable to [redacted] by [redacted] under the [redacted] Agreements as de minimus. It should of course, be taken into account.

Total	$[redacted]

<u>Allocation of Amounts Realized by [redacted]</u>

Reduction in Separation Payments due from [redacted]	$[redacted]
Amount realized on redemption of [redacted] shares[20]	[redacted]
[redacted] Covenant not to Compete	[redacted]
Separation Payments due from [redacted]	[redacted]
Consulting Agreement with [redacted]	[redacted]
Total	$[redacted]
Balance (to Goodwill)	$[redacted]

While the reduction in [redacted]'s obligations to [redacted] for separation payments ($[redacted]) and the [redacted] Covenant not to Compete ($[redacted]) would not generate discharge of indebtedness income to [redacted] due to the provisions of I.R.C. § 108(e)(2),[21] the $[redacted] reduction in the amount due for the redemption of [redacted]'s [redacted] shares would arguably constitute discharge of indebtedness income.

All other benefits receivable by [redacted] as the result of the [redacted] agreements appear to mirror benefits receivable prior to the agreements. Thus, [redacted] retains the right to deferred compensation under the [redacted] Agreement, and the right to a car allowance and health insurance. No mention is made of life insurance under the [redacted] Agreements.

While it is possible for [redacted] to have retained something in the nature of goodwill after the [redacted] Agreements, there is nothing in the file to support taxpayer's contention that the rights passed on to [redacted] in [redacted] were worth $[redacted]. Under these circumstances, it is impossible to give credence to the parties' allocation of all of the $[redacted] payment to [redacted] to goodwill. The more appropriate way to calculate the value of [redacted]'s goodwill is, as suggested above, through the use of the residual method. In this regard, it also should be noted that while Schedule 1 to the [redacted] Separation Agreement appears to give [redacted] a great deal of room in which to practice without violating any covenants not to compete, the [redacted] Asset Acquisition Agreement provides for the sale of a substantial

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20 Not including the $[redacted] payable to [redacted] by [redacted] under the [redacted] Agreements.

21 I.R.C. § 108(e)(2) provides that no discharge of indebtedness income is realized to the extent the payment of the discharged debt would have been deductible.

number of assets normally associated with goodwill to [redacted], including "client lists, referral sources and suppliers." Moreover, the [redacted] Separation Agreement contains draconian provisions applicable when and if [redacted], "directly or indirectly," woos away an existing [redacted] client during the three year period following the date of the agreement, including the payment of three times the [redacted] billings for that client during the year preceding the termination of [redacted]'s services on behalf of that client. It is difficult to believe that, under Schedule 1 of the [redacted] Separation Agreement, [redacted] had the unfettered right to take away [redacted]'s [redacted] Business with a preexisting client prior to the [redacted] Agreements. Put differently, we do not agree that [redacted]'s "goodwill" as of [redacted] extended to [redacted]'s [redacted] Business with respect to existing clients. While we do not hazard a guess as to what the value of [redacted]'s goodwill might have been, we do insist that the value of [redacted]'s goodwill in the [redacted] Business it sold to [redacted] was worth more than the zero consideration assigned to it in the Asset Acquisition Agreement.

Under the residual method, the purchase price for a group of assets is deemed to conclusively establish their value. Next, the value of tangible assets is determined and subtracted from the purchase price to arrive at the value of intangibles. Here, the value of [redacted]'s rights under the [redacted] and [redacted] agreements seem capable of valuation with some degree of certainty. Thus, by taking the purchase price - the amount realized by [redacted] under the [redacted] Agreements, and subtracting the value of the payments under the [redacted] Separation Agreement, the redemption payment, the payment for the covenant not to compete, and the payments under the [redacted] Consulting Agreement, it is possible to conclude that the remainder, $[redacted], represents the value of [redacted]'s goodwill.

It also should be noted that while the purchase price is normally presumed to reflect the value of the assets purchased, evidence may be introduced to rebut that presumption. R.M. Smith, Inc. v. Commissioner, 591 F.2d. 348 (3rd Cir. 1979), affirming 69 T.C. 317 (1977). Here, [redacted] realized $[redacted] in value as the result of the [redacted] Agreements and relinquished a group of assets worth approximately $[redacted] in addition to his "goodwill." While the value of the relinquished assets other than goodwill is susceptible to change, such as, for example, by fluctuations in discount of interest rates and the like, the nature of the assets relinquished, the value of the liquidated sums determined under the [redacted] Agreements represent just that, liquidated values. For this reason, it appears that the use of the residual method of valuation points clearly to adjustments to [redacted]'s [redacted] return in the amounts set forth above.

We are by no means as confident when it comes to the adjustments to [redacted]'s return pursuant to I.R.C. § 1374(a). As noted above, some attempt should be made to value the hard assets transferred to [redacted] pursuant to the [redacted] Asset Acquisition

Agreement. A good start would be to ask the taxpayer to furnish all documents they took into account to determine the values set out in the [redacted] Asset Acquisition Agreement. Since valuations of this type are typically the province of the Examination function, we must leave that determination to your office. However, as intimated above, little respect should be afforded to the parties' failure to allocate any consideration to the goodwill of [redacted]'s [redacted] Business sold to [redacted]. We believe that some attempt should be made to value this goodwill.

SUMMARY AND CONCLUSION

This concludes our advice and recommendation. We are forwarding a copy of this memorandum to the Senior Litigation Counsel (HQ) (CC:LM:MTC:SLC) for mandatory 10 day post review. To assure that our National Office has sufficient time to review our advice, please refrain from taking any action with respect to this issue for a period of 15 days from the date of this memorandum.

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